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Reform of the Stability and Growth Pact

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Executive Summary

The euro area, after a poor growth performance in 2002, has stepped aside in 2003 the word economic recovery. Concurrently, as was easily predictable since its inception, all the flaws of the SGP emerged once the European economy started to loose speed. Compared to the strongly proactive fiscal policy in the US and the UK, Europe remained substantially inertial, with an almost neutral policy stance. As a result, and despite a growth rate of 0.4 % in 2003 — as compared with 3.1 % for the US and 2.3 % for the UK — the area had in 2003 a much lower public deficit than these two countries!

The main flaws of the SGP become then obvious: it lacks flexibility; it is asymmetric; it disregards the intertemporal content of public spending; it neglects the long term sustainability of public finance. The arguments — both theoretical and empirical — in favour of the SGP appear so weak that the question arises if it is not following a hidden agenda.

Reform proposals have been advocated since long and they are not mutually exclusive:

-- to focus on structural deficits

-- to apply the golden rule of public finance, the task of defining what belongs to investment spending being left to the European council and to the European parliament.

-- to take into account long term sustainability, not so much as a mean of punishing high debt countries, but to reward low debt ones.

But even if all these reforms are adopted, the new SGP would at most be a second best solution. The real missing element is an area-wide fiscal policy actor capable of interacting with the ECB, so as to assure an efficient policy-mix. Even if this solution is not conceivable in the present political setting, it may be considered as a benchmark to foster both more coordination inside the European council and more reactivity (i.e. more growth responsibility) from its part.

Fiscal policy in the euro area, the US and the UK: an overview

The Stability and Growth Pact (SGP) is under attack from an increasing number of economists and policy makers. As was easily predictable since its inception, in 1997, all the flaws of the SGP emerged once the European economy started to lose speed. The prolonged stagnation, that lasts since the end of 2000 has been faced by European policy makers with the hands tied. A look at the data reported in table 1 is striking in this respect:

Table I: Growth, deficit and fiscal impulse

	2001	*2002*	*2003*	*2004*
	GDP Growth Rate in %			
USA	0.3	2.2	3.1	4.5
Euro zone	1.5	0.9	0.4	1.4
UK	2.1	1.7	2.3	3.1
	Public Sector Balance in % Of GDP			
USA	0.4	– 3.3	– 4.8	– 5.1
Euro zone[1]	– 1.6	– 2.2	– 2.7	– 2.7
UK	0.9	– 2.1	– 3.2	– 2.8
	Fiscal Impulse in % of GDP			
USA	0.6	3.0	1.7	1.1
Euro zone	0.3	0.5	– 0.2	– 0.3
UK	0.8	2.0	1.2	– 0.2

[1] Net of UMTS receipts

Sources : Eurostat, national accounts, OFCE forecasts 04-2004

The US authorities reacted to the slowdown with a strong expansionary fiscal policy: From 2001 to 2002 the fiscal balance went from a surplus of 0.4% of GDP, to a deficit of 3.3%. This corresponds to a fiscal impulse of 3 points of GDP. In the same year Europe remained substantially inertial, with a policy stance that was almost neutral (to become slightly restrictive in 2003). One of the reasons for this policy inertia (that to a lesser extent also concerned monetary policy) is the constraint imposed on deficit spending by the Stability Pact. In fact, it is striking that the Euro zone has in 2003 a lower deficit than both the US and the UK, in spite of a much lower growth performance. Had Europe had comparable growth rates, we would probably observe much larger differences in measured deficits. In other words it appear as evident that, *regardless of the structural differences in their economies,* the fiscal policy of the US and the European Union differed substantially in facing the slowdown, with the former being far more proactive.

On some flaws of the stability and growth pact[1]

On these two facts – Europe was more inertial than the United States, and the Stability Pact is at least partly responsible for this – there is a widespread consensus among economists. Similarly, there is a substantial consensus on the flaws of the Stability Pact, in its actual formulation, that may be summarized in a few lines.

- *First,* it lacks flexibility; the SGP imposes excessive uniformity of rules, between mature and catching-up countries, or between small and large countries regardless of the rate and variability of growth, of the degree of openness, of investment needs, of contingent liabilities and of the sustainability of public finances.
- *Second*, it is asymmetric, providing no incentive to reduce expenses or to increase revenues during periods of strong growth.
- *Third,* it disregards the public spending intertemporal features, imposing year by year targets even when returns (e.g. of investment) are spread over long time periods. Paradoxically enough it is for this reason inimical to structural reforms which generally imply short term costs and permanent reduction in future spending.
- *Fourth*, it neglects the long term sustainability of public finances, by focusing on deficit rather than debt.

The academic community is far from reaching an agreement on the effects of fiscal policy in a monetary union, and on the need to restrain for example by means of a stability pact. The theoretical debate develops along two lines. The first is the general one on the Keynesian vs. Non-Keynesian effects of fiscal consolidations. Starting from the early 1990s a growing body of literature has argued in favor of expansionary effects of fiscal consolidations that would overcome the standard Keynesian contractionary effects. The bottom line of the argument is that a credible and permanent reduction of budget deficits may have beneficial effects on private sector expectations, and hence induce an increase of private expenditure (be it consumption or investment). In a nutshell, a fiscal consolidation may, under certain conditions, crowd in private expenditure and possibly more than compensate the direct negative effect of public spending reductions predicted by the standard Keynesian argument.

More specifically targeted to monetary Unions, but equally polarized, is the debate on spillover effects. On one side, some argue that a government running a budget deficit has to borrow; in a monetary union this is supposed to raise the common interest rate, and to have adverse effects both on public expenditure (the area-wide increased interest payments reduce government consumption and investment possibilities), and on private consumption and investment in the other countries. This negative externality would induce national governments to run excessive budget deficits, allowing them to make the other countries pay part of `the bill'. An opposite externality argument can be invoked. Suppose a budget deficit expansion occurred in one country. If this were unwarranted, it would result in inflationary pressure, and hence in reduced competitiveness. On the other hand, if the deficit responded to a slump in production it would sustain demand and hence income and imports. In both cases, demand for the

[1] Cf. Jean-Paul Fitoussi, Briefing paper n°4, November 2002.

other countries' production would increase, and their deficit (thanks to increased fiscal revenues) would be reduced.

For both debates, models with one of the two effects prevailing may be easily constructed, so that the answer has to be found in empirical analysis. Unfortunately, evidence on the expansionary effect of fiscal consolidation is inconclusive as well. The Non Keynesian episodes of fiscal contraction are not very numerous, and often associated with specific factors that may have driven the result. For example, they almost always concern small open economies, for which the public expenditure multiplier was small (i.e. the Keynesian effects limited), but the competitive effect very strong. More on this in the following argument. Similarly, a clear-cut response on the sign of the externality has yet to be given.

Thus, it appears clear that the case for a Stability Pact is all but established in the empirical and in the theoretical literature alike.

The Pact has another shortcoming, linked to its *one size fits all* structure, that is becoming clearer as time goes by. In fact, the constraints on public finances imposed by the Pact play differently in large and small countries, with the former paying higher costs. A small open economy, in fact, relies more on external demand than a large one. As a consequence, budgetary restriction is less contractionary, and may actually be expansionary through fiscal competition. For large countries fiscal restraint is costlier in terms of foregone growth. It is not by chance (nor by a genetic predisposition of large country policy makers to vice and incompetence) if nowadays most virtuous countries are small, and the "bad pupils" are the four largest countries of the European Union (the three largest countries of the euro area). That means that the allegedly anti-Keynesians effects of fiscal restrictions are in actuality …. Keynesians. It is not through a virtuous increase of private internal demand that the effect works, but through the increase of external demand which represents typically two third of the GDP of a representative small economy.

A hidden agenda?

In light of the dubious theoretical and empirical support, the strenuous defense of the Pact by virtually anybody (except the governments that have to deal with their electorates) is difficult to understand. In fact, it induces to suspect that the Pact is not defended *per se*, but rather as a means of pushing a broader and 'hidden' agenda. Constraining public finances, sometimes against all logic, could in fact serve the purpose of reducing the role of government in the economy. By depressing growth and employment, it would make the burden of the welfare system heavier, and thus it would make the reform look even more unavoidable and easier for the electorate to swallow.

This would explain why the Pact is not really challenged, but raises two problems. The first is that a tool that had been designed to serve as a short term policy guideline is *de facto* transformed in an instrument to push for long term structural modifications of the

European economies. The second, more important, has to do with democracy in the economic government of Europe. Is it correct to impose to national governments policies that are systematically not validated by their electorates, in the name of an agenda that cannot be explicitly stated because it would certainly be rejected? The latest Commission forecasts on public finances development in Europe show that six countries (France, Germany, Greece, Italy, The Netherlands, Portugal, i.e. 67% and 88% of the EU15 and the Euro area total 2002 GDP at current prices, respectively[2]) are expected to pass the 3% limit imposed by the treaties.

What appears clearly, on the other hand, is that the Stability Pact is only one part of the problem, and that even scrapping it altogether would probably not be enough to revitalize economic policy making in the Euro area. The real missing element is an area-wide fiscal policy actor, capable of interacting with the ECB and to assure an efficient policy mix as happens in the United States. Ideally, a central fiscal policy maker would be able to act in coordination with monetary policy to effectively manage common shocks. This would not only allow more efficient policy making; but it would also take some of the pressure off the shoulders of the ECB, that is at present the only actor supposed to act facing common shocks. By means of transfers a centralized fiscal policy would also be able to deal with region/country specific shocks (or to asymmetric effects of common shocks), exactly as national fiscal policy manage regional shocks.

Reform proposals[3]

Thus, a first best solution would certainly be substituting the Pact, that was originally designed as a decentralized coordination device "from the bottom", with a fully centralized fiscal policy authority. We may even push the argument further and argue that if European integration has to proceed significantly, this solution must be the ultimate outcome of the process.

Of course the first best solution just described is not even conceivable in the present political and institutional conditions, and as such cannot be considered as a valid and realistic option for reforming the current institutional setting.

The same can be said for what I see as the second best solution, namely the abandon of the Stability Pact, and the restoration of national control on fiscal policy. Of course, the problem of how to coordinate twelve (and possibly more in the medium term) national fiscal policies remains, especially in what concerns the relationship with the ECB that is centralized and almost entirely politically unaccountable. But recognizing a problem does not necessarily imply sticking with the *status quo*. It is true that the Pact works as a coordination device for fiscal policies in European countries. But it is actually coordinating them on a bad equilibrium, characterized by inertia, and procyclical fiscal

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[2] And possibly seven if we take into account the limit case of the United Kingdom. (Data taken from the European Commission Spring forecasts, April 2004).

[3] Cf. Jean-Paul Fitoussi and Jérôme Creel : *How to reform the European reform*, London, October 2002.

impulses. In these conditions, it is hard to see how the lack of coordination could perform worse. It is always better to have no coordination, than a bad coordination.

While also politically unfeasible, the solution of scrapping the Stability Pact gives a guideline for assessing the reform proposals that are actually being discussed, and that have some chances of being actually implemented. In fact, I will rank the existing proposals according to the degree to which they allow national governments to regain control of their public finances, and to use them for an active, and countercyclical fiscal policy.

I said that the Pact as it stands has three shortcomings: It prevents automatic stabilizers from acting countercyclically; it penalizes public investment, the most volatile and easily manageable item of public expenditures; it prevents poorer countries to increase public investment in order to sustain their catch-up (the problem will most probably become even more stringent when dealing with the accession countries).

The first desirable modification, on which even the Commission agrees (since November 2002), is shifting the focus from total to structural deficit, thus eliminating all the effects given by the cycle. True, the definition of structural balance relies on a controversial concept, like the output gap. But the benefit of letting automatic stabilizers play would more than compensate the loss of immediacy of the measure.

The second modification, also desirable, would be to exclude from total deficit public investment (the so called *golden rule*, or *dual budget approach*), in order to avoid that short term constraints pose problems on long term growth. The definition of what to include in the category of public investment necessarily implies a degree of arbitrariness, that risks to generate endless bargaining when discussing national stability plans. This problem, though, could be turned into an opportunity: The task of precisely defining what belongs to the category should be given to the Council, that could use it for pushing towards types of expenditure that it deems useful for enhancing growth and competitivity (R&D, new technologies, human capital formation, and so on). More than laws and directives, such a power would put in place a system of incentives and hence could push towards a real European Policy on crucial issues.

Finally, with an eye to long term sustainability, the stock of debt could be taken into account. This should be seen not so much as punishing high debt countries, but rather as rewarding low debt ones. Countries with lower-than-average debt could be given extra leeway, while for the others the 3% limit should continue to hold. After all, a high debt already limits the action of fiscal policy, by means of high interest payments. A second penalty would probably be more harmful than beneficial.

To summarize, a reformed Stability Pact should impose convergence of structural deficit net of public investment. This would assure long term soundness of public finances, leaving room for short term countercyclical policies (at least by letting automatic stabilizers operate freely), and for investment aimed at increasing potential output.

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